The PERAC Financial Bulletin

Financial Market Review, First Quarter 2007

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The first two months of 2007 saw a continuation of the optimism that had led to 2006 being such a good year for investors. This optimism ran up against a wall of worry in late February, however, and most markets struggled to break even for the quarter as investors were reminded that risk is not an obsolete concept.

Following a 9% overnight sell-off in China spurred by fears of a slowing US economy, the US equity market suffered its worst decline in four years on February 27, falling over 3%. Weighed down by fears over the impact of sub-prime mortgage defaults and other ramifications of the housing downturn, as well as by slowing corporate earnings, higher energy prices, and uncertainty over the Fed's next move, the market rebounded from that loss but still ended the quarter generally flat.

The broad market Dow Jones Wilshire 5000 Index was up 1.5%, while the S&P 500 (large cap) index registered a total return of 0.6%. The Russell 2000 (small cap) index rose 1.9% while mid-caps were the place to be as the S&P mid-cap 400 was up 5.8%. The NASDAQ Composite was up 0.3%. There was no decisive advantage between growth and value for the quarter.

Among stock sectors, utilities and natural resources were among the best performers while home construction and mortgage finance were among the worst. Among major stocks, Alcoa (+13.0%), AT&T (+10.3%), and Caterpillar (+9.3%) were among the best while Citigroup (-7.8%), Home Depot (-8.5%), and Johnson & Johnson (-8.7%) lagged.

Recovering from their late February scare, foreign markets continued to perform well. Reflecting a strong worldwide economy, low interest rates, and healthy profits, the MSCI-EAFE Index rose 4.1% for the quarter in dollar terms. (With modest weakness in the dollar, the corresponding return was 3.3% in local currency terms.) With some markets being aided by strong commodity prices and others being hurt by fears of overheating local stock markets, emerging markets overall held their own, up 2.2% for the quarter.

In the bond market, Treasury bond rates declined as investors fled to safety after the setback in the stock market but then rose in late March when the Fed dashed hopes of imminent rate cuts when it said that it was still concerned over "slightly elevated" inflation. Overall, the yield on the 10-year note declined slightly over the quarter, from 4.708% to 4.651%. Another consequence of the Fed statement was that long-term yields rose above short-term rates for the first time in several months, creating the positively sloped yield curve that is the norm for the market. For the quarter, the Lehman Brothers Aggregate Index rose 1.5% while high-yield "junk" bonds rose 2.7%. The high-yield market performed well despite a modest widening of yield spreads.

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Despite continued weakness in residential housing, commercial real estate continued to be an attractive asset class for institutional investors. Publicly-traded REITs were up 3.5% for the quarter while lagged results for private real estate continued to show annualized appreciation in excess of 16%.

Benchmark returns are not yet available for private equity/venture capital or for hedge funds but they are expected to be positive. Ample liquidity, low interest rates, and a healthy IPO market were helping private equity and venture capital. Reflecting the heavy slate of merger and acquisition activity during the quarter, merger arbitrage was seen as the strongest strategy in the hedge fund universe so far this year. Markets were abuzz after The Blackstone Group, a leading private equity firm, announced its intention to go public, a few months after the Fortress Group became the first hedge fund firm to do so.

TOTAL RETURNS | FIRST QUARTER, 2007

INDEX	FIRST QUARTER 2007	ONE YEAR
US EQUITY MARKET		
Dow Jones Industrial Avg.	- 0.30%	+ 13.4%
Standard & Poor's 500 (Large Cap)	+ 0.64%	+ 11.83%
NASDAQ Composite	+ 0.30%	+ 3.50%
Wilshire 5000 (Broad Market)	+ 1.48%	+ 11.43%
Standard & Poor's Mid-Cap 400	+ 5.80%	+ 8.45%
Russell 2000 (Small Cap.)	+ 1.95%	+ 5.91%
GROWTH VS. VALUE		
Russell 1000 (Large Cap) Growth	+ 1.19%	+ 7.06%
Russell 1000 (Large Cap) Value	+ 1.24%	+ 16.83%
Russell Midcap Growth	+ 3.96%	+ 6.90%
Russell Midcap Value	+ 4.86%	+ 17.13%
Russell 2000 Growth	+ 2.48%	+ 1.56%
Russell 2000 Value	+ 1.46%	+ 10.38%
INTERNATIONAL EQUITY		
M.S.C.I. - E.A.F.E.	+ 4.08%	+ 20.20%
M.S.C.I. - Emerging Markets	+ 2.25%	+ 20.65%
FIXED INCOME		
Lehman Brothers Aggregate Index	+ 1.50%	+ 6.60%
Merrill Lynch High Yield Index	+ 2.70%	+ 11.40%
REAL ESTATE		
NAREIT - Equity Real Estate Investment Trusts	+ 3.46%	+ 31.07%
NCREIF Property Index	+ 4.51%	+ 16.60%
	(Q4)	(Trailing 12 months)